BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

I.

Opinions Below.

The opinion of the Board of Tax Appeals (R. 129) is a Memorandum Opinion and, therefore, is not officially reported. The opinion of the Circuit Court of Appeals (Clark, Circuit Judge), is reported in 115 F. (2d) 86.

II.

Jurisdiction.

A statement of the grounds on which the jurisdiction of this Court is invoked is contained in the petition.

III.

Statutes and Regulations Involved.

The pertinent statutes and regulations are set forth in the Appendix, *infra,* pp. 17-19.

IV.

Statement of the Case.

A statement of the essential facts of the case is included in the petition.

V.

Specification of Errors Intended to Be Urged.

The Circuit Court of Appeals erred:

1. In failing to hold that the individual beneficiaries received trust income as such which constituted taxable income to them and an allowable deduction to the trust.

2. In failing to hold, in accordance with the facts, that the income currently distributed to the individual beneficiaries belonged to them from the moment of its receipt by the trust and was taxable to them.

3. In failing to hold that a gift or bequest of income does not lose its character as such by reason of being coupled with a contingent additional or supplementary gift of principal or corpus.

4. In failing to hold that the trust was entitled to the deduction claimed under the explicit and mandatory provisions of section 162(b) of the Revenue Act of 1932 providing that "There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries * * *."

5. In holding that the trust income currently distributed to the individual beneficiaries was taxable to the trust.

6. In affirming the decision of the United States Board of Tax Appeals.

VI.

Argument.

In *Irwin v. Gavit,* 268 U. S. 161 (1925), the rule enunciated by this Court is to the effect that where an instrument makes a gift, bequest or legacy of income to an individual beneficiary, such income is deductible to the trust and taxable to the individual.

In *Burnet v. Whitehouse,* 283 U. S. 148, (1931), this Court had before it for consideration the will of James Gordon Bennett containing the following bequest:

> "Item 'Tenth. I also give and bequeath to the said Sybil Douglas, wife of William Whitehouse, an annuity of five thousand dollars.' "

In *Helvering v. Pardee,* 290 U. S. 365, (1933), the will of Calvin Pardee under consideration by this Court contained a similar bequest as follows:

> "I also give unto my said wife an annuity of Fifty thousand Dollars ($50,000.), to be computed from the date of my decease and to be paid in advance in quarterly payments."

In these two cases, *Burnet v. Whitehouse,* supra, and *Helvering v. Pardee,* supra, this Court held that the sums received by the individual beneficiaries under the instrument "were not gifts to be derived from and paid out of income," and that the payments must be regarded as "not distribution of income; but in discharge of a gift or legacy" and, therefore, taxable to the trustee and not to the beneficiaries.

In the *Gavit* case, it was clear that the individual beneficiaries held no charge against corpus and that

the bequest was a bequest of income which was properly taxable to the beneficiaries.

In the *Whitehouse* and *Pardee* cases, it was equally clear that the bequests in question were not bequests of income and were not distributions of income but were absolute and unconditional bequests made in the ordinary form of bequests creating an immediately existing charge upon the whole estate payable without reference to the existence or absence of income by the fiduciary. By the terms of the instruments themselves, the bequests were not a part of the income to be distributed by the fiduciary. They were rather in the nature of debts payable before the fiduciary should distribute income to the remaining beneficiaries.

The decisions in the *Gavit* case and in the *Whitehouse* and *Pardee* cases are not in conflict. The former relates to liability for tax in the case of distribution of income. The latter relate to liability for tax in the event of a general bequest or legacy. In neither case was there involved an instrument wherein the income distributed by the fiduciary to the beneficiaries might upon the occurrence of a future contingency be supplemented by an additional gift of principal, a case requiring the application of the combined rules laid down in the *Gavit, Whitehouse* and *Pardee* cases.

The instant case is such a case. The whole tenor of the trust instrument executed by John Marshall Lockhart revolves around the collecton and distribution of "income" by the trustee. The trustee is directed to receive and collect all the income of the trust estate and to distribute all such income annually, a part to individual beneficiaries and the balance to or for the use of a charity hospital. The trustee has carried out the provisions of the trust instrument, has collected the in-

come from the estate each year and has distributed such income among the beneficiaries named. In 1932 and 1933, the years involved in this case, the individual beneficiaries paid income tax upon the income received by them where tax was due.

In a subsequent paragraph of the trust instrument, it is provided that in the event that the income available for distribution by the trustees should not be sufficient in any year to pay the amounts that the trustee was directed to pay out of income to the individual beneficiaries, the trustee should withdraw from corpus and pay to the individual beneficiaries sufficient sums to make up the deficiency in such designated amounts. The income has at all times been sufficient, and the trustee has never had occasion to exercise the authority and direction so given. However, it is by reason of this provision that the Commissioner determined in this case that the income which the trustee has been collecting and distributing to the individual beneficiaries year after year has not been income distributed as income. Such a determination is in conflict with the whole tenor of the trust instrument and with the facts. Income collected and distributed as income does not cease to be income because there may be an additional or supplementary gift from principal. In the instant case, it is clear that the individual beneficiaries have never had any claim or charge against corpus and that the trustee has never had the right or power to invade corpus on their behalf. It is clear that only if, as and when, a deficiency in income may occur that a charge against corpus will arise in favor of the individual beneficiaries and that charge will only be for the amount of the deficiency. We submit that until that condition precedent occurs, the trust instrument makes a gift of income and only of income, to which any conditional additional gift of corpus or principal is purely supplementary. The principle gov-

erning the court below was stated in its opinion as follows:

> "The telling phrase used by writers on the law for such a provision is 'threat of corpus invasion.'"

The authority cited for the principle is 49 Yale Law Journal 1496. This is not the test applied by the Supreme Court. As pointed out above, the test under the *Gavit* and *Pardee* cases relates to whether or not there is a distribution of income to the individual beneficiary or the payment of a general legacy.

It is respectfully submitted that under no principle of logic, law or economics could a threat of corpus invasion to supply a partial deficiency in income—which remains a threat only and must so remain until a specified event occurs—change the character of a gift of such income into a gift of principal. Because the test is lacking in sound reason, it seems to be an utterly unsatisfactory guide both from the point of view of the government and the taxpayer.

The indisputable fact, disclosed by the express terms of the trust instrument, is that the individual beneficiaries have never had a right to, charge against, or claim for any part of the corpus, and the trustee has never possessed the slightest right or power to pay over any part of the corpus to or for the benefit of the individual beneficiaries. Under the explicit terms of the trust instrument, the individual beneficiaries will never have any such right, claim, or charge, and the trustee will never have any such right or power unless and until the event established by the instrument—deficiency in income—as a condition precedent occurs, and then such right, claim, or charge will extend only to the amount of such deficiency.

While the United States Circuit Court of Appeals for the Third Circuit in affirming the Board of Tax Appeals in this case held strictly to the principle of "threat of corpus invasion", yet Clark, Circuit Judge, seems to recognize a defect in the universal application of that principle. In his opinion, he states:

> "Under the ruling in the Whitehouse case, the taxability of the trustee became immediately important. To permit him a deduction for income distributed would leave the income entirely untaxed. In Helvering v. Pardee, 290 U. S. 356, the Supreme Court closed the gap by denying the deduction. It is into this closed gap that petitioner, a trustee to pay annuities and administer a charitable trust of the remainder, now seeks an entrance. If it is to be reopened, the responsibility lies elsewhere.
>
> The Supreme Court will have to be convinced of the analogy between the cognate sections 162 (a) and (b). In interpreting sub-section (a) several of the lower Federal Courts have acknowledged reality and 'have allowed the deduction where the expectancy of an ample, continuing income dispels the threat of invasion, and have denied it where the margin is narrow and the prospects uncertain'. A finding of such analogy would put an end to the criticism, a criticism that has taken two forms. First:
>
> > 'A test of income has been adopted which is not the common understanding of the term, nor even the actual source of the payment, but rather the remotely possible source.'
> >
> > Magill, Taxable Income 383
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> Second:
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> > 'One more device for tax avoidance has has been set up because the settlor, by inserting in the trust instrument a power to invade

corpus (even though the prospect of invasion is remote) shifts the burden of taxation to a trustee; multiplication of trusts reduces surtax rates.'

The Power to Invade Corpus in Federal Income Taxation of Trusts, 49 Yale Law Journal 1496, 1499 (note)."

An example of the logical contradiction to which the rule of thumb use of "threat of corpus invasion" leads is illustrated by the case of the *F. G. Bonfils Trust,* 40 B. T. A. 1085, affirmed by the Circuit Court of Appeals for the Tenth Circuit on November 6th, 1940, ... Fed. (2) Page ...., not yet reported.

The will in the case of F. G. Bonfils Trust contained provisions similar to that of the trust instrument in the instant case, and the Circuit Court of Appeals for the Tenth Circuit affirmed the decision of the Board of Tax Appeals, which allowed the deduction provided for in Section 162(a) of the Statute on the ground that "* * * the evidence established beyond a reasonable doubt that there never will be any recourse to the corpus to pay annuities, and that the corpus was, in fact, permanently set aside in the taxable years for charitable purposes.", and yet denied the deduction provided in Section 162(b) for income distributed to the beneficiaries under the identical factual situation because of the so-called "Threat of corpus invasion".

What the Court below has failed to recognize is that there can be, and in the instant case is, a gift of income coupled with a contingent additional or supplementary gift of principal. Such a conclusion is the only logical conclusion from the trust instrument in this case, and insofar as the amount paid to the beneficiary constitutes a distribution of income, such income should be

taxed to the beneficiary. Insofar as the amount paid to a beneficiary constituted a withdrawal from principal (if that event should ever occur), the beneficiary should not be taxed for the amount so withdrawn from principal. Such a principle of taxation is not novel. It is the ordinary and usual method of accounting. It is the principle applied to distribution between life tenant and remainderman where the intact value of the estate is being considered. It is the principle applied by the Commissioner in the taxing of dividends where the question arises as to whether the dividends were paid out of earnings or out of capital. Distribution under the trust in this case is strikingly analogous to payment of dividends by a corporation and taxability to the beneficiary should depend upon whether and to what extent the distribution (dividend) represents a payment out of earnings and not a withdrawal of principal. It is the principle that should be applied to the trust instrument in this case for the following reasons:

(1) It corresponds with the facts, and conforms in letter and in principle to the provisions of Sec. 162(b) of the Revenue Act of 1932.

(2) It is the logical, economic and accounting principle most properly applicable to the trust estate.

(3) It puts an end to the criticism quoted by Clark, Circuit Judge, in his opinion in this case that:

> "A test of income has been adopted which is not the common understanding of the term, nor even the actual source of the payment, but rather the remotely possible source.
> Magill, Taxable Income 383."

(4) It corresponds to administrative procedure in analogous cases and constitutes a satisfactory and

workable basis for both the taxpayer and the government.

(5) All the taxable income of the trust would be taxed and the one who received the income as the owner of the beneficial interest would pay the tax.

Conclusion.

It is, therefore, respectfully submitted that for the reasons stated this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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